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February 15, 2011

## AGENDA ITEM 3c

**TO: MEMBERS OF THE FINANCE COMMITTEE**

- I. SUBJECT:** State Legislative Proposal: Recovery of Additional Audit Costs
- II. PROGRAM:** Legislation
- III. RECOMMENDATION:** Staff recommends that the Board of Administration (Board) **sponsor** legislation to allow CalPERS to assess a reasonable amount on employers to recover additional costs incurred for time which exceeds the estimated time to complete an audit.
- IV. ANALYSIS:**

### **Summary**

This proposal would allow CalPERS to recoup administrative expenses incurred when an audit takes an excessive amount of hours to complete. This change would make the employer directly responsible for the increase in administrative costs rather than distributing the cost among all employers.

### **Background**

Under current law, CalPERS is authorized to recover the costs of administering the system including its audit and other expenses through the administrative fee included in the annual retirement contribution rates. This method distributes the costs associated with excessive audit times among all employers, rather than charging those employers who are directly responsible.

The Office of Audit Services (OFAS) initiated audits of employers in 1990 in response to reports of alleged pension spiking. While originally focusing on contracting agencies, OFAS later expanded these audits to school districts, district agricultural associations, California State University campuses and State agencies. The Public Employees' Retirement Law (PERL) requires employers to provide information or make available documents and records as deemed necessary by the Board to determine the correctness of retirement benefits, reportable compensation, enrollment in, and reinstatement to CalPERS membership.

The audits examine a number of different areas, including:

- The accuracy of reported payrate and special compensation
- Utilization of the proper payroll reporting elements
- Coverage group classification
- CalPERS contract provisions
- Employment of retired annuitants
- Retirement reporting of unused sick leave for additional service credits
- Membership eligibility and enrollment procedures of:
  1. Temporary/Part-time Employees
  2. Independent Contractors
  3. Employees working through a Temporary Employment Agency
  4. Optional membership
  5. Joint Powers Authorities and other separate entities

Depending on the size of the agency, an OFAS auditor generally will be on site at an agency anywhere from three days to two weeks. Some of the records that auditors review are:

- Payroll registers
- Personnel files
- Salary schedules and wage reports (W-2's, DE-6's)
- Written labor policies and/or agreements for all employees
- Governing Board Minutes
- CalPERS Listings and Summary Reports
- Financial Statements Audited by a CPA firm
- IRS forms 1099-MISC
- Reports that monitor the hours worked for temporary employees and retired annuitants

Once the audit is complete, OFAS provides a confidential draft report to the agency. The agency is given the opportunity to respond to the draft report and its comments are included in the final report. Copies of the final report are distributed within CalPERS to the Board, as well as the following program areas: Employer Services Division, Benefits Services Division, and the Office of Employer and Member Health Services. The program areas work collaboratively with the agency to resolve any issues identified by the audit.

Since 1990, OFAS has performed approximately 900 employer audits, and is expected to complete 54 audits in fiscal year 2010-2011 and 89 audits in fiscal year 2011-2012.

In 2006, OFAS expanded its audits to include health benefits eligibility and enrollment processes for employers contracting for the CalPERS Health Benefits program under the Public Employees' Medical and Hospital Care Act (PEMHCA).

The PEMHCA is the governing authority for the CalPERS Health Benefits Program, and outlines agency responsibilities to include:

- Ensuring eligible members are offered PEMHCA health coverage
- Keeping accurate and up-to-date records of all enrollment related information (such as, birth certificates, marriage certificates, divorce decrees, etc.)
- Timely informing CalPERS of any change in member enrollment or status

Auditors review agencies' health benefits eligibility and enrollment processes, and records retention practices, including:

- Copies of birth certificates, marriage certificates and divorce decrees
- Affidavits of Eligibility (HBD-35) for economically dependent children
- Declarations of Domestic Partnership for domestic partners
- Dependents' social security numbers

### **Discussion**

In the past, some audits have required an excessive amount of time to complete due either to a lack of cooperation or poor internal controls and recordkeeping on the part of the employer.

Recently, a contracting agency undergoing an audit provided OFAS with more than 30,000 documents in response to a request for specific employee records. OFAS and other CalPERS staff spent hundreds of hours going through the documents, only to find that many of the specified documents needed to complete the audit had not been provided. When requested to provide the needed documentation, the contracting agency again provided thousands of additional documents, which required many more hours of CalPERS staff time to find the key documents.

In another recent audit of a different contracting agency, OFAS requested documents, and was met with a lack of cooperation. Consequently, OFAS auditors spent an extraordinary number of hours at the site to obtain the documents necessary to assess the correctness of retirement benefits, reportable compensation, and membership.

Both audits required OFAS staff time in excess of the hours that OFAS would have estimated for completion of an audit of a comparable employer and resulted in large unanticipated administrative costs to CalPERS.

This proposal would provide a means for CalPERS to recover costs from employers whose actions (i.e. lack of cooperation or poor internal controls and recordkeeping) were the cause of the additional administrative costs associated with an audit.

### **Proposed Changes**

This proposal would make the following changes in existing law:

- Require the Board to notify an employer of the estimated time to complete an audit prior to initiating the audit
- Identify the factors on which the estimate is based
- Authorize CalPERS to assess a reasonable fee on an employer to recover its additional costs when the time required to complete an audit exceeds the estimate

### **Legislative History**

- 2004 Chapter 190 (AB 2355, Oropeza) – Requires CalPERS to provide, upon the request of a contracting agency, the agency's dollar share of administrative costs. *CalPERS Position: Neutral*
- 2002 Chapter 898 (SB 1536, Soto) – Among other things, authorizes the board to audit the books and records of employers to determine their compliance with the Public Employees' Medical and Hospital Care Act. *CalPERS Position: Sponsor*
- 1994 Chapter 636 (AB 1799, Speier) – Among other things, clarifies CalPERS authority to audit the books and records of contracting agencies, the State and school employers. *CalPERS Position: Sponsor*
- 1970 Chapter 435 (AB 618, Barnes) – Authorizes the board to assess a contracting agency a reasonable amount to cover costs incurred because of the Agency's failure to submit reports and forward contributions on a timely basis. *CalPERS Position: None*

## **V. STRATEGIC PLAN**

This proposal supports Strategic Goal III to develop, design, and administer benefit programs and business processes that are innovative, effective, efficient, and valued by our members, employers, and stakeholders.

## **VI. FISCAL IMPACT**

### **Program Cost**

Increased administrative costs for employers who fail to comply.

### **Administrative Cost**

Unknown, but likely minor costs for CalPERS staff to calculate and recover the additional costs for time spent performing an audit that exceeds the estimate, which will be offset by reasonable amounts assessed on those employers responsible for the additional costs.

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